

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:WAS:POSTF-156674-01

WABaker

date:

3/22/02

to: Team Manager, Team 1121, Fairfax, Virginia
Team Manager, Team 1916, Fairfax, Virginia

from: Assistant Area Counsel (Heavy Manufacturing and Transportation)
Washington, D.C.

subject: Dollar Roll Transactions

Taxpayer: [REDACTED] Corporation

TIN: [REDACTED]

Address: [REDACTED]

Year: Calendar Year [REDACTED]

This is in response to your request for our review of the Form 886 "explanation of items" section relative to a proposed revenue agent report that explains the adjustment for dollar roll transactions entered into by [REDACTED] Corporation ("taxpayer") during calendar year [REDACTED]. On March 14, 2002, members of the examination team met with us and attorneys from the Office of Associate Chief Counsel (Financial Institutions and Products) to discuss both the dollar roll transactions and the proposed explanation for the adjustment. The meeting ended with agreement that the narrative section should be rewritten. The following, in the format prescribed in IRM 4.2.8.10.2, is our recommended explanation for the dollar roll adjustment.

* * * *

Dollar Roll Transactions

\$ [REDACTED]

Facts:

Taxpayer claimed a deduction of \$ [REDACTED] as a result of dollar roll transactions. The deduction was included with "other deductions" on line 26 of Form 1120; the components of these "other deductions" are enumerated on Schedule 3 of the return. Dollar rolls are variations of repurchase agreements: taxpayer agrees to sell mortgage-backed securities to a dealer and to repurchase an equal amount of "substantially the same" (but not identical) securities at a future date and at a set price. The

transactions are generally considered financings for financial accounting purposes. Statement of Financial Accounting Standards No. 125, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, ¶¶ 9-12 and 237(b). The transactions are sales for tax purposes. I.R.C. § 1001; Treas. Reg. 1.1001-3.

The mortgage-backed securities involved in each of the dollar roll transactions were taxpayer's [REDACTED]. [REDACTED] contain taxpayer's guarantee that the [REDACTED] holders will receive timely payment of both interest and principal. Taxpayer's retained portfolio includes all of its mortgages and guaranteed mortgage securities assets. See [REDACTED] (consolidated balance sheets). Taxpayer, for financial accounting, is required to identify items in its retained portfolio as held for one of three purposes: [REDACTED]

[REDACTED] Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities. Specifically, taxpayer is required to identify on its books a category for each security it owns.

Taxpayer's retained portfolio is accounted for in a computer database and it assigns one of the following [REDACTED] codes to each security in its retained portfolio: [REDACTED]

[REDACTED]. As of [REDACTED] taxpayer's retained portfolio was as follows:

\$ [REDACTED]	[REDACTED]
[REDACTED]	[REDACTED]
\$ [REDACTED]	[REDACTED]

See [REDACTED]. All of the [REDACTED] used in the dollar roll transactions came from account '[REDACTED]'

Taxpayer, for tax purposes, identified its retained portfolio as follows:

\$ [REDACTED]	Ending inventory
[REDACTED]	Held-for-investment
\$ [REDACTED]	

See Tax Return, Schedule A and Statements 4-5 (ending inventory), Schedule L and Statement 7; Rev. Rul. 97-39, 1997-2 C.B. 62 (Item

6). The ending inventory was valued at market as required by I.R.C. § 475(a); the held-for-investment securities were valued at amortized cost as permitted by I.R.C. § 475(b). All of the [REDACTED] used in the dollar roll transactions had been identified as held-for-investment.

Applicable Law:

I.R.C. § 1221(a) defines capital asset. I.R.C. § 1236(b) provides that losses by dealers in securities from the sale or exchange of any security shall in no event be considered as ordinary if the security was clearly identified in the dealer's records as a security held for investment. I.R.C. § 7121 provides for closing agreements.

Taxpayer's Positions:

The Service should enter into a closing agreement agreeing that all sales of Mortgages held by taxpayer generate ordinary gains and losses. This is the same kind of agreement that the Service entered into with [REDACTED]

The securities used in the dollar roll transactions should be classified as I.R.C. § 1221(a)(1) or (a)(4) property for tax purposes.

Argument:

I.R.C. § 7121(a) provides that "[t]he Secretary is authorized to enter into closing agreements in writing with any person relating to the liability of such person (or the person or estate for whom he acts) in respect of any internal revenue tax for any taxable period. Taxpayer has not provided a sufficiently compelling reason for the Service to enter into a closing agreement.

I.R.C. § 1221(a)(1) property is defined as "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." All of the securities used in the dollar roll transactions were at all times identified as held-to-maturity. There is no factual support for taxpayer's contention that these securities ever qualified as I.R.C. § 1221(a)(1) property while in taxpayer's possession.

I.R.C. § 1221(a)(4) property is defined as "accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1)." The dollar roll transactions were security trades entered into with other security dealers, no services were provided by any party to these transactions and, as discussed above, the securities involved were not I.R.C. § 1221(a)(1) property.

Conclusion:

Taxpayer's losses from the dollar roll transactions were capital losses.

* * * *

If you have a question, please contact Special Litigation Assistant Wilton A. Baker. His telephone number is (202) 634-5403 ext. 269.

CAROL E. SCHULTZE
Assistant Area Counsel